Outlook amidst the chaos

Nazmeera Moola, Head of SA Investments at Ninety One

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THE CURRENT SITUATION

After several weeks of complacency, financial markets tipped into full-blown panic on 24 February as COVID-19 continued to spread. As a result of the virus, markets are scrambling to price in the impact on the global economy of both a supply shock and a demand shock.

The supply shock is driven by the closure of a large portion of Chinese manufacturing capacity for several weeks in late January. This has been followed by the implementation of travel bans by the US, New Zealand and South Africa – among others.

The data shows a significant decline in manufacturing output in China in January and February. Exports were down 17.2% from a year earlier in February. The PMI fell from 51.9 in January into deep contractionary territory of 27.5 in February. Though supply chains were carrying inventory into the Chinese lunar new year, these will quickly be depleted. While factories in China have now reopened, the prospect of economic shutdowns across most of Western Europe and the US (to contain the spread of the virus so that healthcare systems can cope with the resultant, mostly elderly, pneumonia victims) over the next week is increasingly becoming the base case.

The recent shutdowns in China, Italy and Spain, partial shutdowns in France and Germany, and potential shutdowns in a range of other countries are generating a negative global demand shock as people have limited their trips to shopping malls, self-quarantined, or cancelled travel plans. This may generate inflation in time – but it seems unlikely for now.

The initial decline in oil prices was due to the demand shock as fuel demand plunged. For example, Lufthansa has cancelled 50% of their flights. The geopolitical battle between Russia and Saudi Arabia has exacerbated the problem greatly.

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These combined supply and demand shocks have created the conditions for a contraction in global growth in the first half of 2020. This will be aggravated by the likely halt to fixed investment in the coming months, as companies are unable to make decisions amid the current chaos.

After the fall in equity prices, a global recession is increasingly being priced in – but this doesn't mean that markets have found a floor. Markets have shifted beyond the paradigm of "Okay, Italy is another Hubei – but China, Korea, Taiwan, HK, Singapore and Japan have managed this well. And Europe and the US will do better than Italy." However, they have not shifted all the way to "the US is another Italy." Recent events have also begun to raise concerns about the sustainability of the corporate debt build-up, particularly in the US. The week of 9 to 13 March saw the biggest ever weekly outflows from investment-grade and high-yield credit markets and emerging market debt. Conversely, this resulted in the biggest inflow ever into cash.

The primary source of the problem is the multiplying new cases of COVID-19. We would expect new countries to follow the path we have seen in Wuhan as the numbers accelerate for two to three weeks and then the growth rate starts to slow before the eventual numbers plateau. As long as the number of confirmed cases in a number of northern hemisphere countries continues to rise exponentially, there will be uncertainty on the shape of the recession or how long it will be until economies start to recover. Until that changes, it will be very difficult for markets to rally. Medical experts indicate that a vaccine is at least a year away, though antivirals (which alleviate the symptoms of the virus) could be available in 2020 and are likely to have a big impact on the mortality and severity of COVID-19 cases.

OUR PROGNOSIS

1. Volatility is here to stay for some time, or at least until COVID-19 cases stabilise.
2. Authorities will attempt to provide significant monetary and fiscal support. Unfortunately, the room for rate cuts is limited. Before Lehman's collapse in 2008, the large developed-market central banks had combined interest rates of 4150 basis points (bps). On 2 March 2020, that number was 600bps. On 16 March 2020, it was 325bps. The potential for rate cuts is negligible compared to 12 years ago. Total negative-yielding debt in the world now stands at US$15 trillion due to quantitative easing. As monetary policy becomes more impotent, the fiscal response will ramp up. Australia has already announced an AUD17.6 billion stimulus package. The US will be providing stimulus of US$50 billion by funding small business, deferring tax payments and providing payroll tax relief. China will provide a massive stimulus package. Eventually, this stimulus will provide the conditions for a significant rally in equity markets.
3. While equity and risk markets have begun to price in a global recession, health and economic developments could easily drive markets lower in the short term.
4. Positioning is much cleaner after the recent dramatic sell-off. While most investors started hoping last week for a reasonable resolution relatively soon, that theory is increasingly being abandoned. In addition, selling by passive funds and systematic investors seems to be done.
5. Companies and countries with balance sheet risk need to implement self-help. The best thing South Africa can do is control its public sector wage bill and take all possible moves to boost growth. Government has repeatedly committed to progress on the wage bill in the financial year starting 1 April 2020. Markets remain sceptical. Concrete progress will be very positive for SA bonds.

The conclusion is that when COVID-19 data stabilises, markets are likely to rally strongly. However, there is no clarity on how long that will take. If the global economy remains weak through 2020, markets can fall further. It therefore seems prudent to be cautious for now.

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The improvement in the global economy will take time. As one of the larger airlines recently noted, it took their demand 14 months to fully recover after the SARS outbreak. They expect the recovery from COVID-19 to take at least 18 months. However, given the unprecedented scale of shutdowns, they are going to wait until they actually start seeing demand recover before they reinstitute capacity or "loosen the reins on any discretionary OpEx and CapEx."

In South Africa, President Cyril Ramaphosa has taken dramatic action to both limit the flow of infected people into South Africa and to slow the spread of the virus within South Africa. On Monday, 23 March 2020, he announced a nationwide lockdown from 26 March to 16 April 2020.

If this move – and the others President Ramaphosa set in place the week before – results in the progress of the virus in South Africa looking more like it has in South Korea and Singapore, rather than it has in Italy and Spain, then South African asset prices will benefit. Unfortunately, South Africa does not have the fiscal room to support businesses and labour that developed markets are likely to provide.

Most notably, South African government borrowing costs have moved higher in recent days as emerging market debt funds have seen large-scale outflows. Compare this to the US where the government can borrow at 0% interest rates and use that money to support the economy.

As impossible as it is to look a few months ahead in this period of crisis, it is worth keeping in mind that the local equity market, the bond market and currency all look cheap. Relative to history, the JSE is currently the cheapest of the liquid exchanges in the world. The potential global recession will intensify the SA recession. However, if China rebounds strongly in the second half of this year, it will support commodity prices. With most factories back at work in China, this looks distinctly possible. In addition, South Africa has had a massive terms of trade boost due to the decline in oil prices. This will help inflation in the short-term – and leave South African real interest rates at the short and longer end of the yield curve, looking among the most attractive in the world.

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